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SIPDIS

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SENSITIVE, SIPDIS

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TAGS: ECON EFIN CE
SUBJECT: Sri Lanka Tax mess

¶1. (U) Summary: The cost of doing business in Sri Lanka is set to rise, due to increased taxation and tax complexity. International trade is also subject to high taxation in the form of increased non-tariff fees and surcharges. However, the impact of higher taxes is not equitable. For companies entitled to tax holidays, the impact (and the tax liability) is relatively low. Tax incentives offered to attract investments have lowered potential tax revenue from a large number of companies. End Summary.

New taxes

¶2. (U) The Parliament recently approved or amended several tax laws to enforce tax proposals contained in the Government of Sri Lanka's (GSL) 2006 budget. Key among the new tax instruments is a cumbersome Stamp Duty (SD), which will apply to several business instruments/transactions including affidavits, mortgage payments, rentals, various types of receipts, insurance policies, credit card charges and salaries. In most cases, the tax rate is relatively low, but would complicate business transactions by requiring purchase and affixing of stamps to documents-the processing of which is already burdensome in Sri Lanka. In other instances, the duty will be withheld and sent to the Inland Revenue Department (by the merchant directly) as in the case of the SD on credit cards and salaries. The government will also continue a 0.1% tax on all bank debits. Tax experts say the stamp duty and the debit tax could result in a "tax on tax" situation, as they are applied more than once on money exchanging for a single transaction. For example, since most people pay credit card bills through bank checks or by withdrawing money from a bank, the transaction would be taxed twice under the debit tax and stamp duty.

Thin capitalization and transfer pricing

¶3. (SBU) For the first time, Sri Lanka is to introduce rules on thin capitalization (which limits a company's tax breaks on loans made by shareholders - allowing shareholders to keep their capital base "thin" and finance through debt while writing off debt payments). Some tax experts are concerned about the introduction of these advanced concepts in Sri Lanka and suggest the country is not yet ready for such sophisticated taxation, while others believe that they will bring Sri Lanka's tax structure in line with global

developments. According to Premila Perera, Tax Partner at KPMG, Sri Lanka will be one of the first developing countries to introduce the thin capitalization concept and has gone further than many countries by including both related domestic and foreign debt. According to Perera, in most countries, thin capitalization is introduced only to cover related party foreign debt.

¶4. (U) The government will also introduce transfer pricing rules using the "arm's length" principle (which uses prices applied to sales to third parties on related party transactions). However, Sri Lanka does not have enough data to determine arm's length pricing, thus requiring income tax assessors of the Inland Revenue Department to determine the applicability of rules.

Corporate and Personal Income taxes are going up
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¶5. (U) Reversing a previous Government's decision to gradually reduce the highest income tax rates to 20%, both corporate and personal tax rates were increased from April 1, 2006. The highest tax band on corporate and personal tax was increased to 35% from 30%. The government will also continue with an additional Social Responsibility Levy (SRL) (the procedures from which fund child protetion activities) on income tax, which has been icreased to 1% from 0.25%. Over the years, the goernment has begun to disallow various business epenses when determining profits. Currently, it does not allow companies to deduct a range of expenses such as advertising (limited to 50%), overseas business trips and entertainment expenses.

¶6. (U) The Banking community has raised concerns over

increasing financial sector taxes. Banks pay corporate income tax and an additional Value Added Tax (VAT) on earnings. The overall tax rate on banks will rise to about 60% in 2006. Several bank CEO's have made public statements complaining about the high tax environment. They claim that high tax rates in the midst of higher capital adequacy requirements, high levels of non-performing loans and necessary technology upgrades does not bode will for the industry. They assert that the high tax rates will result in higher transaction costs over the long term.

Taxes on international trade also rising

¶7. (U) Meanwhile, Sri Lanka is continuing with a range of taxes on international trade. The taxes include import duty, an import duty surcharge, import fees, a Port and Airports tax (PAL), SRL and VAT. Some imports are also subject to an excise fee. VAT applies to both imports and domestic production and services. Many of these taxes have been increased in each successive budget over the past three years. Other new taxes, such as a tax on foreign movies, are also contemplated. Several US companies have complained to the Embassy regarding the high level of taxation on imports.

Tax collections remain Low

¶8. (U) The recent moves to increase taxes indicate that the private sector will have to bear the brunt of the government's fiscal profligacy. With a projected budget deficit of 9.1% of GDP in 2006, the Sri Lankan government is hard pressed to find funds to cover expenses. Sri Lanka's tax collections were about 14% of GDP in 2005 and the government hopes to increase tax collection to about 16% of GDP in 2006. Most taxes come from indirect taxes. Direct taxes on income contribute only about 16% of tax revenue.

¶9. (U) There are many reasons for low tax revenue. Tax incentives and tax holidays offered to encourage investments

by the Board of Investment (BOI) are key reasons for low levels of direct taxation from the corporate sector, especially from foreign investors. For example, Dialog Telekom, an investment by Malaysia Telecom and Sri Lanka's largest listed company, which made a profit of Rs 7 billion (USD 70 million) in 2005 is exempted from corporate tax due to a 15 year tax holiday. Its tax liability will be limited to just 0.6% of profits, via the Economic Service Charge (a minimum tax on the exempted companies) and tax on interest income. Similarly, while there is a wave of new high rise apartment buildings shooting up around Colombo, none is likely to bring tax revenue due to tax holidays (unless they are foreign owned, in which case there is a 100% tax on the land value). Many exporting companies are also subject to various tax incentives. These tax incentives exclude some of the most profitable companies from taxation.

¶10. (U) Another reason for sluggish tax revenue is the loss of traditional sources of revenue, such as certain import duties, due to tariff concessions offered under bilateral and multilateral trade agreements including the Indo-Lanka Free trade agreement (ILFTA). Imports of inputs and production related items by exporting companies are also free of import duty. Government tax experts have indicated that to compensate for tax losses arising from duty concessions granted under bilateral trading arrangements, taxes on imports from other countries will need to be increased. Import levies appear to be a relatively painless domestic political device - less controversial to a political base than broadening the income tax base or raising VAT.

¶11. (U) Weak tax administration is a vulnerability. Tax evasion is thought to be high. Out of a workforce of approximately 10 million, only 143,704 individuals file tax returns. In addition, there are 194,847 private sector workers who pay taxes under the mandatory Pay-As-you-Earn (PAYE) tax scheme

Concerns

¶12. (SBU) While increased taxation seems to conform with the President's vision of bridging the rich-poor gap, tax experts say the government should not add additional taxes, but should instead focus on increasing the tax base. At a recent KPMG tax seminar, Premila Perera noted that the new taxes and tax concepts will increase the complexity of the tax system, and suggested that private sector CEO's should pay increased attention to risk management and corporate governance in this high tax environment. The higher tax rates could also worsen Sri Lanka's economic freedom rankings (Heritage Foundation) used by the Millennium Challenge Corporation (Sri Lanka already faces low rankings in the budget deficit and inflation categories).

¶13. (U) Government efforts to increase taxation come at a time when the Inland Revenue Department (IRD) has come under close public scrutiny following the revelation of a tax fraud. Several former senior officers of the IRD and businessmen have been arrested following a scam in which more than Rs 3.5 billion (USD 35 million) had been fraudulently paid out as VAT refunds. (Note: VAT paid on imports consumed by exporting companies is refunded, but genuine companies experience long delays in getting the refunds.) Speaking at the KPMG seminar, Richard Ebell, Vice Chairman of Hayleys Ltd, one of Sri Lanka's largest companies, expressed concern over the lack of controls in the tax system in light of the huge fraud. He noted that Hayleys is experiencing serious problems in collecting VAT refunds amounting to Rs 500 million (USD 5 million). A previous reform effort to strengthen tax collection under a single Revenue Authority has been abolished.

¶14. (SBU) Srilal Ahangama, Group Finance Director of Maharaja Organization, one of Sri Lanka's largest privately held companies, told Econ FSN that Sri Lanka's tax system has always been complex and businesses just accept it. He said his company would seek to find ways to lower the tax burden within the tax law. Nilanthi Sivapragasam, Financial Controller of Aitken Spence Group, another large publicly held conglomerate, said that they are not overly worried about the 5% increase in corporate taxation, but are highly concerned about new rules on thin capitalization and transfer pricing. According to her these rules would have a direct impact on groups of companies with many subsidiaries like Aitken Spence. According to Sivapragasam, these concepts are usually applied to monitor multi-national company (MNC) operations. However, Sri Lanka is to apply these rules to cover local subsidiaries. According to her estimates, the government earnings from these moves would not be significant. Several companies have made representations to the government on these rules, and it is not clear if the government will change them.
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